Supreme Court, U.S.
FILED
APR 21 1980
MICHAEL RODAK, JR., CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1979

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Nos. 1470 and 1471

THE STATE TEACHERS RETIREMENT SYSTEM OF OHIO PENSION FUND

and

LEHMAN BROTHERS, INC.,

Petitioners,

against

LEO and LOYCE LILLY, *et al.*,

Respondents.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR RESPONDENTS LEO AND LOYCE LILLY IN OPPOSITION

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Opinions Below

The relevant opinions below are the opinions of the Court of Appeals for the Second Circuit reported at 608 F.2d 55 (also annexed to Lehman Petition at 14a) and that of the Southern District of New York reported at CCH Fed. Sec. Law Rptr. ¶ 96,769 (annexed to Lehman Petition at 1a).

Jurisdiction

The jurisdictional requisites are adequately set forth in the petitions.

Statutes and Regulations Involved

15 U.S.C. § 78j(b). [§ 10(b) of the Securities Exchange Act of 1934].

17 C.F.R. § 240.10b-5. [Rule 10b-5 promulgated pursuant to § 10(b) of the Securities Exchange Act of 1934].

Statement of the Case

This is a class action on behalf of all persons who were purchasers from The State Teachers Retirement System of Ohio Pension Fund ("Ohio") of any of the 80,000 shares of Guardian Mortgage Investors ("Guardian") common stock sold by Ohio in a secondary distribution (the "Secondary") through Lehman Brothers, Inc. ("Lehman") on or about March 20, 1974. The claim is that Lehman and Ohio violated Rule 10b-5 by structuring the Secondary with the advantage of non-public information which, when disclosed nine days after the Secondary, caused the market price of the Guardian shares to drop precipitously.

The case was succinctly described in the opinion of the Court of Appeals for the Second Circuit, reversing the decision of the district court granting defendants' motions for a directed verdict under Rule 50(a) F.R. Civ. P., as follows:

> "This appeal arises from allegations that a real estate investment trust, or REIT, with approximately $400,000,000 in assets, known as Guardian Mortgage Investors, or GMI, on the eve of the issuance of its annual audit results in the Spring of 1974, disclosed to

one of its principal financial advisors, Lehman Brothers Incorporated, that the REIT's 'problem loans' had increased in the three months since its last public statement on the subject from $7,000,000 to $16,000,000 or $18,000,000. This inside information, it is alleged, was passed on by the brokerage firm to The State Teachers Retirement System of Ohio Pension Fund, another Lehman Brothers' client, which thereafter sold 80,000 shares of the REIT's stock to plaintiffs and the class they represent by means of a secondary offering, managed by Lehman Brothers, without disclosure of the inside information to the purchasers. Nine days after the secondary offering, the REIT made public information that it was substantially increasing its loss reserves and that its dividends would be substantially lower than those paid the preceding year. As a result, the stock fell precipitously and plaintiffs suffered an immediate loss on their investment.

At the conclusion of plaintiffs' case the court below dismissed plaintiffs' complaint, which alleged violations of § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5, thereunder, and granted motions for directed verdicts in favor of Lehman Brothers and its pension fund client. The court concluded that the jury could not rationally find that the inside information said to have been 'tipped' by the REIT to Lehman Brothers and by Lehman Brothers to the pension fund was material, or that Lehman Brothers and its client acted with an intent to defraud or to deceive in selling the 80,000 shares of the REIT's stock to the uninformed public. Since our examination of the record reveals evidence on the basis of which a jury could have reasonably concluded that the *'tip'* was material and that the sale by the 'tippees' was accomplished with knowledge of the tip's materiality and with fraudulent and deceptive intent to take advantage of the public's ignorance, we

reverse in order that the issues raised by plaintiffs' complaint may be resolved by jury." (Opinion, Lehman petition, pp. 14a-16a).

As stated, the Court of Appeals reversed and remanded the action to the district court for a new trial.

Argument

It is important to emphasize the context in which the case comes to this Court. The class action claim was tried to a jury. Plaintiffs' sole evidence was documents and testimony of defendants, or those aligned with them. The evidence clearly established a "tip" of non-public information from Guardian to Lehman, but much of plaintiffs' theory of liability against Ohio related to inferences to be drawn from direct evidence and circumstantial evidence. The trial court directed a verdict for both defendants. The Second Circuit remanded for a new trial.

In reversing and remanding the Court of Appeals cited, quoted and clearly applied the test established by this Court in *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438 (1976) on the issue of materiality, the key issue on appeal. The Court, in applying the *TSC* test concluded it was "error for the court to conclude as a matter of law that investor interest in the increase in GMI's problem loans [from $7 million to $16-18 million] would have disappeared . . ." (Opinion, Lehman petition, p. 23a). We respectfully submit the Court of Appeals was correct in the decision it reached. Furthermore, as spelled out below there are no significant policy issues warranting review by this Court.

POINT I

The Court below properly applied the decision of this Court in *TSC Industries, Inc.* v. *Northway, Inc.*

Both petitioners recognize that the critical question on appeal was the application of the standard of materiality for the non-public information Lehman obtained before doing the Secondary for Ohio. Both petitioners recognize, as they must, the standard for materiality in the context of a disclosure case arising under the federal securities laws is governed by this Court's decision in *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438 (1976). Lehman in its petition (p. 8) quotes the following from *TSC Industries* (p. 449) as the true test of materiality:

> "a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of the information made available."

This test has three critical elements. First, a "*would have* assumed" or "*would have* been viewed" approach is taken. This is to be contrasted with a lower standard using "*could have*" or "*might have*" which this Court used in an earlier decision in *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 153 (1972).

Second, an objective standard is used by referring to the "reasonable investor."

Third, the disclosure in issue is considered in the context of significantly altering the "total mix" of information available.

The Court below in making its analysis of materiality stated (Opinion, Lehman petition, pp. 19a-20a):

> "In this context, it seems clear that there was substantial basis in the record for submitting to the jury the question whether information concerning the level and the trend pursued by GMI's problem loans was the kind of information which a reasonable investor would want to know before deciding whether to purchase the REIT's stock, and, in particular, whether information, that the level of problem loans as calculated by management had increased from $7,000,000 to $16,000,000 or $18,000,000 over a three-month period, would be regarded by a reasonable investor 'as having significantly altered the "total mix" of information . . . available' concerning the REIT's financial condition. *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438, 449, S.Ct. 2126, 2132, 48 L.Ed.2d 757 (1976)."

Thus, the Court specifically cited *TSC Industries,* and the "would" test (as opposed to "could", "might" or some other), specifically referred to the "reasonable investor": and specifically referred to the impact of the Guardian problem loan information in the context of the "total mix" of information available. Accordingly, the Court below meticulously applied the appropriate standard.

Both petitioners, however, assert the standard for materiality was indeed lowered by the Second Circuit, despite its apparent homage to *TSC Industries.* Both petitioners argue this by seizing on the Court's words:

> "He [reasonable investor] also has an interest in obtaining information which renders it impossible to assess the value of his investment with any reasonable certainty . . ." (see Lehman petition, pp. 10-11 and Ohio petition, pp. 9-11).

Both, in effect, argue that the quoted portion requires potential disclosure of great amounts of necessarily un-

informative information and by so doing the Court thereby diluted and distorted the *TSC Industries* test it purported to apply. Petitioners, unfortunately, distort the Court's thought by excising from the partially quoted sentence the following:

> ". . . and turns an otherwise reasonable investment into a speculative one." (Opinion, Lehman petition, p. 24a).

The full sentence as written by the Court is:

> "He [i.e. a reasonable investor] has an interest in obtaining information which renders it impossible to assess the value of his investment with any reasonable certainty *and turns an otherwise reasonable investment into a speculative one.*" (Emphasis supplied).

The excised portion is crucial. All investments are not of equal risk or stability. REIT stocks, such as Guardian, were considered stable income producing securities. The REITs, including Guardian, until March 1974, essentially had a record of steadily increasing quarterly income and dividend increases. Guardian specifically, since its formation in 1970, had an impressive record of successive quarterly income and dividend increases, except for one quarter in 1973.* Once this record or pattern was threatened, the source and likelihood of change was information of the utmost interest to any reasonable investor. This is both obvious and logical and, by so stating, the Court of Appeals did not depart from the *TSC Industries* test of materiality which it quoted and applied.

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* Guardian's growth record was established at trial and emphasized in the brief on appeal.

POINT II

The Court properly considered Lehman's reaction to the tip.

Lehman makes the argument that the Court below considered the Lehman reaction to the non-public information it received as "not important" in resolving the issue of materiality. (Lehman petition, pp. 12-14).

The reaction by Lehman, asserted by plaintiffs and the class and clearly recognized by the Court, was the action taken to induce Ohio to sell its Guardian shares, sell them as quickly as possible, and to sell them at an immediate discount of $1.75 per share on the Secondary as contrasted with $.35 per share charge if the shares were sold over whatever period necessary on the New York Stock Exchange where they were listed.

The Court below specifically stated (Opinion, Lehman petition, p. 20a):

> "Indeed, the manner in which the information was regarded by those privy to it and the importance attached to the information by the recipients after the 'tip' could be found to have been given, cf. S.E.C. v. Bausch & Lomb, Inc., 565 F.2d 8, 18 (2d Cir. 1977), were entirely consistent with a conclusion that the information was material information."

The Court thereafter specifically addressed the reaction of the trial witnesses, including Lehman employees, by analyzing their actions subsequent to the receipt of the tip. The Court specifically discussed, among other factors, the manner in which Lehman prepared an internal memorandum labeled "Not For Distribution Outside of Lehman Brothers." (Opinion, Lehman petition, p. 21a). At best Lehman's argument on this point, really does no more than raise the question of whether the Court meant what it said, a very dubious basis for requesting review by this Court.

POINT III

There is no conflict in the Circuits.

Ohio asserts that a conflict exists among the Circuits and within the Second Circuit itself as to the test of materiality. Ohio recognizes the appropriateness of *TSC Industries* test using whether a "reasonable man would attach importance to the information in making an investment decision." (Ohio petition, pp. 12-16). In discussing the conflict, Ohio cites the following six cases (and only these six cases) as potentially in conflict with the *TSC* test.

Chasins v. *Smith Barney & Co.,* 438 F.2d 1167, 1171 (2d Cir. 1970); *SEC* v. *Shapiro,* 494 F.2d 1301 (2d Cir. 1974); *Sonesta International Hotels Corp.* v. *Wellington Associates,* 483 F.2d 247 (2d Cir. 1973); *Kohler* v. *Kohler & Co.,* 319 F.2d 634, 642 (7th Cir. 1963); *Myzel* v. *Fields,* 386 F.2d 718, 734 (8th Cir. 1967); *Hidell* v. *International Diversified Investments,* 520 F.2d 529 (7th Cir. 1975).

It is more than significant to note that all six decisions predate 1976, the date of the *TSC Industries* decision. While as a purely technical matter a conflict may exist between the test of materiality used in these six decisions and that applied in *TSC,* it is highly unlikely that panels of the Second, Seventh or Eighth Circuits would follow their own earlier decision and ignore the Supreme Court *TSC* decision. Accordingly, no present conflict exists which warrants resolution by this Court.

Finally, Ohio argues that review by this Court is warranted since *TSC Industries* applies to Section 14(a) of the Securities Exchange Act, 15 U.S.C. § 78n(a), and not the much litigated Section 10(b) and Rule 10b-5 under which this case arises. (Ohio petition, p. 16). The answer to this is, as co-petitioner Lehman readily recognizes, that this Court has made plain that *TSC* does apply to 10(b)

actions in *S. D. Cohn & Co.* v. *Woolf*, 426 U.S. 944 (1976) and *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462 (1977) at 474 n.14.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the petitions for a writ of certiorari should be denied.

Respectfully submitted,

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